Statement of Financial Position or Balance sheet

Statement of Financial Position, also known as the balance sheet presents the financial position of an entity at a given date. It is comprised of three main components: Assets, Liabilities and Shareholders' Equity. Statement of Financial Position helps users of financial statements to assess the financial soundness of an entity in terms of liquidity risk, financial risk, credit risk and business risk.

Statement of Financial Position as at 31st December 2015

	Notes	2015	2014
		USD	USD
ASSETS			
Non-current assets			
Property, plant & equipment	**9**	**130,000**	120,000
Goodwill	**10**	**30,000**	30,000
Intangible assets	**11**	**60,000**	50,000
		220,000	200,000
Current assets			
Inventories	**12**	**12,000**	10,000
Trade receivables	**13**	**25,000**	30,000
Cash and cash equivalents	**14**	**8,000**	10,000
		45,000	50,000
TOTAL ASSETS		**265,000**	250,000
EQUITY AND LIABILITIES			
Equity			
Share capital	**4**	**100,000**	100,000
Retained earnings		**50,000**	40,000
Revaluation reserve	**5**	**15,000**	10,000
Total equity		**165,000**	150,000
Non-current liabilities			
Long term borrowings	**6**	**35,000**	50,000
Current liabilities			
Trade and other payables	**7**	**35,000**	25,000
Short-term borrowings	**8**	**10,000**	8,000
Current portion of long-term borrowings	**6**	**15,000**	15,000
Current tax payable	**9**	**5,000**	2,000
Total current liabilities		**65,000**	50,000
Total liabilities		**100,000**	100,000
TOTAL EQUITY AND LIABILITIES		**265,000**	250,000

COMPONENTS OF THE BALANCE SHEET

Balance sheet consists of the following key elements:

ASSETS

An asset is something that an entity owns or controls in order to derive economic benefits from its use. Assets must be classified in the balance sheet as current or non-current depending on the duration over which the reporting entity expects to derive economic benefit from its use. An asset which will deliver economic benefits to the entity over the long term is classified as non-current whereas those assets that are expected to be realized within one year from the reporting date are classified as current assets.

Assets are also classified in the statement of financial position on the basis of their nature:

- Tangible & intangible: Non-current assets with physical substance are classified as *property, plant and equipment* whereas assets without any physical substance are classified as *intangible assets*. Goodwill is a type of an intangible asset.
- Inventories balance includes goods that are held for sale in the ordinary course of the business. Inventories may include raw materials, finished goods and works in progress.
- Trade receivables include the amounts that are recoverable from customers upon credit sales. Trade receivables are presented in the statement of financial position after the deduction of allowance of bad debts.
- Cash and cash equivalents include cash in hand along with any short term investments that are readily convertible into known amounts of cash.

LIABILITIES

A liability is an obligation that a business owes to someone and its settlement involves the transfer of cash or other resources. Liabilities must be classified in the statement of financial position as current or non-current depending on the duration over which the entity intends to settle the liability. A liability which will be settled over the long term is classified as non-current whereas those liabilities that are expected to be settled within one year from the reporting date are classified as current liabilities.

Liabilities are also classified in the statement of financial position on the basis of their nature:

- Trade and other payables primarily include liabilities due to suppliers and contractors for credit purchases. Sundry payables which are too insignificant to be presented separately on the face of the balance sheet are also classified in this category.
- Short term borrowings typically include bank overdrafts and short term bank loans with a repayment schedule of less than 12 months.
- Long-term borrowings comprise of loans which are to be repaid over a period that exceeds one year. Current portion of long-term borrowings include the installments of long term borrowings that are due within one year of the reporting date.
- Current Tax Payable is usually presented as a separate line item in the statement of financial position due to the materiality of the amount.

SHAREHOLDERS' EQUITY

Equity is what the business owes to its owners. Equity is derived by deducting total liabilities from the total assets. It therefore represents the residual interest in the business that belongs to the owners. Equity is usually presented in the statement of financial position under the following categories:

- Share capital represents the amount invested by the owners in the entity
- *Retained Earnings* comprises the total net profit or loss retained in the business after distribution to the owners in the form of dividends

- *Revaluation Reserve* contains the net surplus of any upward revaluation of property, plant and equipment recognized directly in equity

The balance sheet is structured in a manner that the total assets of an entity equal to the sum of liabilities and equity. This may lead you to wonder as to why the balance sheet must always be in equilibrium. Assets of an entity may be financed from internal sources (i.e. share capital and profits) or from external credit (e.g. bank loan, trade creditors, etc.). Since the total assets of a business must be equal to the amount of capital invested by the owners (i.e. in the form of share capital and profits not withdrawn) and any borrowings, the total assets of a business must equal to the sum of equity and liabilities.

This leads us to the accounting equation: Assets = Liabilities + Shareholders' Equity

Statement of financial position helps users of financial statements to assess the financial health of an entity. When analyzed over several accounting periods, balance sheet may assist in identifying underlying trends in the financial position of the entity. It is particularly helpful in determining the state of the entity's liquidity risk, financial risk, credit risk and business risk. When used in conjunction with other financial statements of the entity and the financial statements of its competitors, balance sheet may help to identify relationships and trends which are indicative of potential problems or areas for further improvement. Analysis of the statement of financial position could therefore assist the users of financial statements to predict the amount, timing and volatility of entity's future earnings.

INCOME STATEMENT OR ROFIT & LOSS ACCOUNT

Income Statement, *also known as Profit & Loss Account*, is a report of income, expenses and the resulting profit or loss earned during an accounting period.

Income Statement for the Year Ended 31st December 2015

	Notes	2015 USD	2014 USD
Revenue	**16**	**120,000**	100,000
Cost of Sales	**17**	**(65,000)**	(55,000)
Gross Profit		**55,000**	45,000
Other Income	**18**	**17,000**	12,000
Distribution Cost	**19**	**(10,000)**	(8,000)
Administrative Expenses	**20**	**(18,000)**	(16,000)
Other Expenses	**21**	**(3,000)**	(2,000)
Finance charges	**22**	**(1,000)**	(1,000)
		(15,000)	(15,000)
Profit before tax		**40,000**	30,000
Income tax	**23**	**(12,000)**	(9,000)
NET PROFIT		**28,000**	21,000

Income statement is prepared on the accruals basis of accounting.

This means that income (including revenue) is recognized when it is **earned** rather than when receipts are realized *(although in many instances income may be earned and received in the same accounting period).* Conversely, expenses are recognized in the income statement when they are **incurred** even if they are paid for in the previous or subsequent accounting periods.

Income statement does not report transactions with the owners of an entity.

Hence, dividends paid to ordinary shareholders are not presented as an expense in the income statement and proceeds from the issuance of shares is not recognized as an income. Transactions between the entity and its owners are accounted for separately in the statement of changes in equity.

Incomes statement comprises of the following main elements:
Revenue
Revenue includes income earned from the principal activities of an entity. So for example, in case of a manufacturer of electronic appliances, revenue will comprise of the sales from electronic appliance business. Conversely, if the same manufacturer earns interest on its bank account, it shall not be classified as revenue but as other income.

Cost of Sales

Cost of sales represents the cost of goods sold or services rendered during an accounting period. Hence, for a retailer, cost of sales will be the sum of inventory at the start of the period and purchases during the period minus any closing inventory. In case of a manufacturer however, cost of sales will also include production costs incurred in the manufacture of goods during a period such as the cost of direct labor, direct material consumption, and depreciation of plant and machinery and factory overheads

Other income consists of income earned from activities that are not related to the entity's main business. For example, other income of an entity that manufactures electronic appliances may include:
Gain on disposal of fixed assets
Interest income on bank deposits
Exchange gain on translation of a foreign currency bank account

Distribution cost includes expenses incurred in delivering goods from the business premises to customers.

Administrative expenses generally comprise of costs relating to the management and support functions within an organization that are not directly involved in the production and supply of goods and services offered by the entity.
Salary cost of executive management
Legal and professional charges
Depreciation of head office building
Rent expenses of management and admin offices
Cost of functions / departments not directly involved in production such as finance department, HR department and administration department

Finance charges usually comprise of interest expense on loans and debentures

Income tax consists of current period’s estimated tax charge, prior period tax adjustments and deferred tax.

Income Statement provides the basis for measuring performance of an entity over the course of an accounting period. Performance can be assessed from the income statement in terms of the following:
Change in sales revenue over the period and in comparison to industry growth
Change in gross profit margin, operating profit margin and net profit margin over the period
Increase or decrease in net profit, operating profit and gross profit over the period
Comparison of the entity's profitability with other organizations operating in similar industries or sectors

STATEMENT OF CASH FLOWS

Statement of Cash Flows, *also known as cash flow statement* presents the movement in cash flows over the period as classified under operating, investing and financing activities.

ABC PLC

Statement of Cash Flows for the year ended 31 December 2015

	Notes	2015 USD	2014 USD
Cash flows from operating activities			
Profit before tax		**40,000**	35,000
Adjustments for:			
Depreciation	**4**	**10,000**	8,000
Amortization	**4**	**8,000**	7,500
Impairment losses	**5**	**12,000**	3,000
Bad debts written off	**14**	**500**	-
Interest expense	**16**	**800**	1,000
Gain on revaluation of investments		**(21,000)**	-
Interest income	**15**	**(11,000)**	(9,500)
Dividend income		**(3,000)**	(2,500)
Gain on disposal of fixed assets		**(1,200)**	(1,850)
		35,100	40,650
Working Capital Changes:			
Movement in current assets:			
(Increase) / Decrease in inventory		**(1,000)**	550
Decrease in trade receivables		**3,000**	1,400
Movement in current liabilities:			
Increase / (Decrease) in trade payables		**2,500**	(1,300)
Cash generated from operations		**39,600**	41,300
Dividend paid		**(8,000)**	(6,000)
Income tax paid		**(12,000)**	(10,000)
Net cash from operating activities (A)		**19,600**	25,300
Cash flows from investing activities			
Capital expenditure	**4**	**(100,000)**	(85,000)
Purchase of investments	**11**	**(25,000)**	-
Dividend received		**5,000**	3,000
Interest received		**3,500**	1,000
Proceeds from disposal of fixed assets		**18,000**	5,500
Proceeds from disposal of investments		**2,500**	2,200

Net cash used in investing activities (B)		**(96,000)**	(73,300)
Cash flows from financing activities			
Issuance of share capital	**6**	**1000,000**	-
Bank loan received		**-**	100,000
Repayment of bank loan		**(100,000)**	-
Interest expense		**(3,600)**	(7,400)
Net cash from financing activities (C)		**896,400**	92,600
Net increase in cash & cash equivalents (A+B+C)		**820,000**	44,600
Cash and cash equivalents at start of the year		**77,600**	33,000
Cash and cash equivalents at end of the year	**24**	**897,600**	77,600

Cash and cash equivalents generally consist of the following:

- Cash in hand
- Cash at bank
- Short term investments that are highly liquid and involve very low risk of change in value (therefore usually excludes investments in equity instruments)
- Bank overdrafts in cases where they comprise an integral element of the organization's treasury management (e.g. where bank account is allowed to float between a positive and negative balance (i.e. overdraft) as opposed to a bank overdraft facility specifically negotiated for financing a shortfall in funds (in which case the related cash flows will be classified under financing activities)

As income statement and balance sheet are prepared under the accruals basis of accounting it is necessary to adjust the amounts extracted from these financial statements (e.g. in respect of non-cash expenses) in order to present only the movement in cash inflows and outflows during a period.

All cash flows are classified under operating, investing and financing activities as discussed below:

Operating activities

Cash flow from operating activities presents the movement in cash during an accounting period from the **primary revenue generating** activities of the entity.

For example, operating activities of a hotel will include cash inflows and outflows from the hotel business (e.g. receipts from sales revenue, salaries paid during the year etc.) but interest income on a bank deposit shall not be classified as such (i.e. the hotel's interest income shall be presented in investing activities).

Profit before tax as presented in the income statement could be used as a starting point to calculate the cash flows from operating activities.

Following adjustments are required to be made to the profit before tax to arrive at the cash flow from operations:

- Elimination of non-cash expenses (e.g. depreciation, amortization, impairment losses, bad debts written off, etc.
- Removal of expenses to be classified elsewhere in the cash flow statement (e.g. interest expense should be classified under financing activities

- Elimination of non-cash income (e.g. gain on revaluation of investments)
- Removal of income to be presented elsewhere in the cash flow statement (e.g. dividend income and interest income should be classified under investing activities unless in case of for example an investment bank)
- Working capital changes (e.g. an increase in trade receivables must be deducted to arrive at sales revenue that actually resulted in cash inflow during the period)

Investing activities

Cash flow from investing activities includes the movement in cash flow as a result of the purchase and sale of assets other than those which the entity primarily trades in (e.g. inventory). So for example, in case of a manufacturer of cars, proceeds from the sale of factory plant shall be classified as cash flow from investing activities whereas the cash inflow from the sale of cars shall be presented under the operating activities.

- Cash flow from investing activities consists primarily of the following:
- Cash outflow expended on the purchase of investments and fixed assets
- Cash inflow from income from investments
- Cash inflow from disposal of investments and fixed assets

Financing activities

Cash flow from financing activities includes the movement in cash flow resulting from the following:

- Proceeds from issuance of share capital, debentures & bank loans
- Cash outflow expended on the cost of finance (i.e. dividends and interest expense)
- Cash outflow on the repurchase of share capital and repayment of debentures & loans.

Statement of cash flows provides important insights about the liquidity and solvency of a company which are vital for survival and growth of any organization. It also enables analysts to use the information about historic cash flows to form projections of future cash flows of an entity (e.g. in NPV analysis) on which to base their economic decisions. By summarizing key changes in financial position during a period, cash flow statement serves to highlight priorities of management. For example, increase in capital expenditure and development costs may indicate a higher increase in future revenue streams whereas a trend of excessive investment in short term investments may suggest lack of viable long term investment opportunities. Furthermore, comparison of the cash flows of different entities may better reveal the relative quality of their earnings since cash flow information is more objective as opposed to the financial performance reflected in income statement which is susceptible to significant variations caused by the adoption of different accounting policies.